

§ 1.381(c)(4)-1 Method of accounting.

(a) *Introduction*—(1) *Purpose*. This section provides guidance regarding the method of accounting or combination of methods (other than inventory and depreciation methods) an acquiring corporation must use following a distribution or transfer to which sections 381(a) and 381(c)(4) apply and how to implement any associated change in method of accounting. See § 1.381(c)(5)-1 for guidance regarding the inventory method an acquiring corporation must use following a distribution or transfer to which sections 381(a) and 381(c)(5) apply. See § 1.381(c)(6)-1 for guidance regarding the depreciation method an acquiring corporation must use following a distribution or transfer to which sections 381(a) and 381(c)(6) apply.

(2) *Carryover method requirement for separate and distinct trades or businesses*. In a transaction to which section 381(a) applies, if an acquiring corporation continues to operate a trade or business of the parties to the section 381(a) transaction as a separate and distinct trade or business after the date of distribution or transfer, the acquiring corporation must use a carryover method as defined in paragraph (b)(5) of this section for each continuing trade or business, unless either the carryover method is impermissible and must be changed under paragraph (a)(4) of this section or the acquiring corporation changes the carryover method in accordance with paragraph (a)(5) of this section. The carryover method requirement applies to the overall method of accounting (for example, an accrual method of accounting) and any special method of accounting (for example, the percentage of completion method of accounting described in section 460) as defined in paragraph (b)(2) of this section used by each trade or business after the date of distribution or transfer. The acquiring corporation need not secure the Commissioner's consent to continue a carryover method.

(3) *Principal method requirement for trades or businesses not operated as separate and distinct trades or businesses*. In a transaction to which section 381(a) applies, if an acquiring corporation does not operate the trades or busi-

nesses of the parties to the section 381(a) transaction as separate and distinct trades or businesses after the date of distribution or transfer, the acquiring corporation must use a principal method determined under paragraph (c) of this section, unless either the principal method is impermissible and must be changed under paragraph (a)(4) of this section or the acquiring corporation changes the principal method in accordance with paragraph (a)(5) of this section. The principal method requirement applies to the overall method of accounting (for example, the cash receipts and disbursements method of accounting) and any special method of accounting (for example, the installment method under section 453) as defined in paragraph (b)(2) of this section used by each integrated trade or business after the date of distribution or transfer. The acquiring corporation must change to a principal method in accordance with paragraph (d)(1) of this section for each integrated trade or business and need not secure the Commissioner's consent to use a principal method.

(4) *Carryover method or principal method not a permissible method*. If a carryover method or principal method is not a permissible method of accounting, the acquiring corporation must secure the Commissioner's consent to change to a permissible method of accounting as provided in paragraph (d)(2) of this section. If the acquiring corporation must use a single method of accounting for a particular item after the date of distribution or transfer regardless of the number of separate and distinct trades or businesses operated on that date, the acquiring corporation must use the principal method for that item as determined under paragraph (c) of this section, unless either the principal method is impermissible and must be changed under this paragraph (a)(4) or the acquiring corporation changes the principal method in accordance with paragraph (a)(5) of this section.

(5) *Voluntary change*. Any party to a section 381(a) transaction may request permission under section 446(e) to change a method of accounting for the taxable year in which the transaction occurs or is expected to occur. For

trades or businesses that will not operate as separate and distinct trades or businesses after the date of distribution or transfer, a change in method of accounting for the taxable year that includes that date will be granted only if the requested method is the method that the acquiring corporation must use after the date of distribution or transfer. The time and manner of obtaining the Commissioner's consent to change to a different method of accounting is described in paragraph (d)(2) of this section.

(6) *Examples.* The following examples illustrate the rules of this paragraph (a). Unless otherwise noted, the carryover method is a permissible method of accounting.

Example (1). Carryover method for separate and distinct trades or businesses after the date of distribution or transfer. (i) *Facts.* X Corporation operates an employment agency that uses the overall cash receipts and disbursements method of accounting. T Corporation operates an educational institution that uses an overall accrual method of accounting. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. After the date of distribution or transfer, X Corporation operates the employment agency as a trade or business that is separate and distinct from the educational institution.

(ii) *Conclusion.* Because after the date of distribution or transfer X Corporation operates the employment agency as a separate and distinct trade or business, under paragraph (a)(2) of this section X Corporation must use the carryover method for each continuing trade or business, unless either the carryover method is impermissible and must be changed under paragraph (a)(4) of this section or X Corporation changes the carryover method in accordance with paragraph (a)(5) of this section. As defined in paragraph (b)(5) of this section, the carryover method for the employment agency is the cash receipts and disbursements method of accounting and the carryover method for the educational institution is the accrual method of accounting used by T Corporation immediately prior to the date of distribution or transfer. There is no change in method of accounting, and X Corporation need not secure the Commissioner's consent to use either carryover method.

Example (2). Carryover method for a special method of accounting. (i) *Facts.* X Corporation provides personal grooming consulting and T Corporation provides weight management consulting. Both X Corporation and T Corporation use the same overall accrual method of accounting. X Corporation has elected

to use the recurring item exception under §1.461-5. T Corporation does not use the recurring item exception. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. After the date of distribution or transfer, X Corporation operates the personal grooming consulting business as a trade or business that is separate and distinct from the weight management consulting business.

(ii) *Conclusion.* Because after the date of distribution or transfer, X Corporation operates the personal grooming consulting business as a separate and distinct trade or business, under paragraph (a)(2) of this section X Corporation must use a carryover method for each continuing trade or business, unless either the carryover method is impermissible and must be changed under paragraph (a)(4) of this section or X Corporation changes the carryover method in accordance with paragraph (a)(5) of this section. As defined in paragraph (b)(5) of this section, the carryover method for the overall method of accounting for each trade or business is the accrual method used immediately prior to the date of distribution or transfer. The carryover method for the special method of accounting for the personal grooming consulting business is the recurring item exception under §1.461-5 while the carryover method for the weight management consulting business is not to use the recurring item exception under §1.461-5. There is no change in method of accounting, and X Corporation need not secure the Commissioner's consent to use the carryover methods of accounting.

Example (3). Carryover method for a special method of accounting not permissible. (i) *Facts.* X Corporation is an engineering firm that uses the overall cash receipts and disbursements method of accounting and has elected under section 171 to amortize bond premium with respect to its taxable bonds acquired at a premium. T Corporation is a manufacturer that uses an overall accrual method of accounting and has not made a section 171 election to amortize bond premium with respect to its taxable bonds acquired at a premium. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. After the date of distribution or transfer, X Corporation operates the engineering firm as a trade or business that is separate and distinct from the manufacturing business.

(ii) *Conclusion.* Because after the date of distribution or transfer X Corporation operates the engineering firm as a separate and distinct trade or business, under paragraph (a)(2) of this section X Corporation must use a carryover method for each continuing trade or business, unless either the carryover method is impermissible and must be changed under paragraph (a)(4) of this section or X Corporation changes the carryover method in accordance with paragraph (a)(5)

of this section. As defined in paragraph (b)(5) of this section, the carryover method for the overall method of accounting for the engineering firm is the cash receipts and disbursements method used by X Corporation immediately prior to the date of distribution or transfer, and the carryover method for the overall method of accounting for the manufacturing business is the accrual method used by T Corporation immediately prior to the date of distribution or transfer. There is no change in method of accounting, and X Corporation need not secure the Commissioner's consent to use either carryover method. Notwithstanding that after the date of distribution or transfer X Corporation has two separate and distinct trades or businesses, X Corporation is permitted only one method of accounting for amortizable bond premium under section 171. Because after the date of distribution or transfer X Corporation must use a single method of accounting for bond premium for all trades or businesses, X Corporation must use the principal method for that item as determined under paragraph (c) of this section, unless either the principal method is impermissible and must be changed under paragraph (a)(4) of this section or X Corporation changes that method in accordance with paragraph (a)(5) of this section. X Corporation must change to the principal method in accordance with paragraph (d)(1) of this section. If amortizing bond premium is not the principal method, X Corporation may make an election to amortize bond premium to the extent permitted by section 171. See paragraph (e)(2) of this section for rules on making elections.

(b) *Definitions.* For purposes of this section—

(1) *Method of accounting.* A method of accounting has the same meaning as provided in section 446 and any applicable Internal Revenue Regulations.

(2) *Special method of accounting.* A special method of accounting is a method expressly permitted or required by the Internal Revenue Code, Income Tax Regulations, or administrative guidance published in the Internal Revenue Bulletin that deviates from the normal application of the cash receipts and disbursements method or an accrual method of accounting. The installment method under section 453, the mark-to-market method under section 475, the amortization of bond premium under section 171, the percentage of completion method under section 460, the recurring item exception of § 1.461-5, and the income deferral methods under section 455 and § 1.451-5 are

examples of special methods of accounting. See § 1.446-1(c)(1)(iii).

(3) *Adoption of a method of accounting.* Adoption of a method of accounting has the same meaning as provided in § 1.446-1(e)(1).

(4) *Change in method of accounting.* A change in method of accounting has the same meaning as provided in § 1.446-1(e)(2).

(5) *Carryover method.* A carryover method for the overall method of accounting is the overall method of accounting that each party to a section 381(a) transaction uses for each separate and distinct trade or business immediately prior to the date of distribution or transfer. The carryover method for a special method of accounting for an item is the special method of accounting for that item that each party to a section 381(a) transaction uses for each separate and distinct trade or business immediately prior to the date of distribution or transfer.

(6) *Principal method.* A principal method is an overall or special method of accounting that is determined under paragraph (c) of this section.

(7) *Permissible method of accounting.* A permissible method of accounting is a method of accounting that is proper or permitted under the Internal Revenue Code or any applicable Income Tax Regulations.

(8) *Acquiring corporation.* An acquiring corporation has the same meaning as provided in § 1.381(a)-1(b)(2).

(9) *Distributor corporation.* A distributor corporation means the corporation, foreign or domestic, that distributes its assets to another corporation described in section 332(b) in a distribution to which section 332 (relating to liquidations of subsidiaries) applies.

(10) *Transferor corporation.* A transferor corporation means the corporation, foreign or domestic, that transfers its assets to another corporation in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if—

(i) The transfer is in connection with a reorganization described in section 368(a)(1)(A), (a)(1)(C), or (a)(1)(F), or

(ii) The transfer is in connection with a reorganization described in section 368(a)(1)(D) or (a)(1)(G), provided the requirements of section 354(b) are met.

(11) *Parties to the section 381(a) transaction.* Parties to the section 381(a) transaction means the acquiring corporation and the distributor or transferor corporation that participate in a transaction to which section 381(a) applies.

(12) *Date of distribution or transfer.* The date of distribution or transfer has the same meaning as provided in section 381(b)(2) and § 1.381(b)–1(b).

(13) *Separate and distinct trades or businesses.* Separate and distinct trades or businesses has the same meaning as provided in § 1.446–1(d).

(14) *Gross receipts.* Gross receipts means all the receipts, including amounts that are excludible from gross income, that must be taken into account under the method of accounting used in a representative period (determined without regard to this section) for federal income tax purposes. For example, gross receipts includes income from investments, amounts received for services, rents, total sales (net of returns and allowances), and both taxable and tax-exempt interest. See paragraph (e)(5) of this section for rules on determining the representative period.

(15) *Audit protection.* Audit protection means, for purposes of paragraph (d)(1) of this section, that the IRS will not require an acquiring corporation that is required to change a method of accounting under paragraph (a)(3) of this section to change that method for a taxable year ending prior to the taxable year that includes the date of distribution or transfer.

(16) *Section 481(a) adjustment.* The section 481(a) adjustment means an adjustment that must be taken into account as required under section 481(a) to prevent amounts from being duplicated or omitted when the taxable income of an acquiring corporation is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year.

(17) *Cut-off basis.* A cut-off basis means a manner in which a change in method of accounting is made without a section 481(a) adjustment and under which only the items arising after the beginning of the year of change (or, in the case of a change made under para-

graph (d)(1) of this section, after the date of distribution or transfer) are accounted for under the new method of accounting.

(18) *Adjustment period.* The adjustment period means the number of taxable years for taking into account the section 481(a) adjustment required as a result of a change in method of accounting.

(19) *Component trade or business.* A component trade or business is a trade or business of a party to the section 381(a) transaction that will be combined and integrated with a trade or business of the other party to the section 381 transaction. See paragraph (e)(4)(ii) of this section for the determination of whether a trade or business is operated as a separate and distinct trade or business after the date of distribution or transfer.

(c) *Principal method—(1) In general.* For each integrated trade or business, the principal method is generally the method of accounting used by the component trade or business of the acquiring corporation immediately prior to the date of distribution or transfer. If, however, the component trade or business of the distributor or transferor corporation is larger than the component trade or business of the acquiring corporation on the date of distribution or transfer, the principal method is the method used by the component trade or business of the distributor or transferor corporation immediately prior to that date. If the larger component trade or business does not have a special method of accounting for a particular item immediately prior to the date of distribution or transfer, the principal method for that item is the method of accounting used by the component trade or business that does have a special method of accounting for that item. See paragraph (e)(9) of this section for special rules concerning methods of accounting that are elected on a project-by-project, job-by-job, or other similar basis. For each integrated trade or business, the component trade or business of the distributor or transferor corporation is larger than the component trade or business of the acquiring corporation on the date of distribution or transfer if—

(i) The aggregate of the adjusted bases of the assets held by each component trade or business of the distributor or transferor corporation (determined under section 1011 and any applicable Income Tax Regulations) exceeds the aggregate of the adjusted bases of the assets of each component trade or business of the acquiring corporation immediately prior to the date of distribution or transfer, and

(ii) The aggregate of the gross receipts for a representative period of each component trade or business of the distributor or transferor corporation exceeds the aggregate of the gross receipts for the same period of each component trade or business of the acquiring corporation. See paragraph (e)(5) of this section for rules on determining the representative period.

(2) *Multiple component trades or businesses with different principal methods.* If a party to the section 381(a) transaction has multiple component trades or businesses and more than one principal overall method of accounting or more than one principal special method of accounting for an item, then the acquiring corporation may choose which of the principal methods of accounting used by such component trades or businesses will be the principal methods of the integrated trade or business. The acquiring corporation must choose a principal method that is a permissible method of accounting. In general, a change to a principal method in a transaction to which section 381(a) and paragraph (a)(3) of this section applies is made under paragraph (d)(1) of this section.

(3) *Examples.* The following examples illustrate the rules of this paragraph (c). Unless otherwise noted, the principal method is a permissible method of accounting.

Example (1). Principal method is the method used by the acquiring corporation. (i) *Facts.* X Corporation and T Corporation each operate an employment agency. X Corporation uses the overall cash receipts and disbursements method of accounting, and T Corporation uses an overall accrual method of accounting. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. The adjusted bases of the assets in X Corporation's employment agency immediately prior to the date of distribution or transfer exceed the adjusted bases of

the assets in T Corporation's employment agency, and the gross receipts in X Corporation's employment agency for the representative period exceed the gross receipts of T Corporation's employment agency for the period. After the date of distribution or transfer, X Corporation's employment agency will not be operated as a trade or business that is separate and distinct from T Corporation's employment agency.

(ii) *Conclusion.* Because after the date of distribution or transfer X Corporation will not operate its employment agency as a separate and distinct trade or business, X Corporation must use a principal method under paragraph (a)(3) of this section, unless either the principal method is impermissible and must be changed under paragraph (a)(4) of this section or X Corporation changes the principal method in accordance with paragraph (a)(5) of this section. Because on the date of distribution or transfer T Corporation's employment agency is not larger than X Corporation's employment agency, the principal method for the overall method of accounting is the cash receipts and disbursements method used by X Corporation's employment agency. X Corporation need not secure the Commissioner's consent to use this method of accounting. However, in accordance with paragraph (d)(1) of this section, X Corporation must change the method of accounting for the employment agency acquired from T Corporation to the cash receipts and disbursements method.

Example (2). Principal method is the method used by the acquiring corporation. (i) *Facts.* The facts are the same as in *Example (1)*, except that the gross receipts of T Corporation's employment agency for the representative period exceed the gross receipts of X Corporation's employment agency for the period.

(ii) *Conclusion.* The result is the same as in *Example (1)*. Although the gross receipts of T Corporation's employment agency exceed the gross receipts of X Corporation's employment agency, T Corporation's employment agency is not larger than X Corporation's employment agency because the adjusted bases of the assets of T Corporation's employment agency do not exceed the adjusted bases of the assets of X Corporation's employment agency. Thus, the principal method for the overall method of accounting is the cash receipts and disbursements method of accounting used by X Corporation's employment agency immediately prior to the date of distribution or transfer. X Corporation need not secure the Commissioner's consent to use this method of accounting. However, in accordance with paragraph (d)(1) of this section, X Corporation must change the method of accounting for the employment agency business acquired from T Corporation to the cash receipts and disbursements method.

Example (3). Principal method is the method used by the distributor or transferor corporation. (i) *Facts.* The facts are the same as in *Example (2)*, except that the adjusted bases of the assets held by T Corporation's employment agency immediately prior to the date of distribution or transfer exceed the adjusted bases of the assets held by X Corporation's employment agency.

(ii) *Conclusion.* The principal method for the overall method of accounting is the accrual method of accounting used by T Corporation's employment agency immediately prior to the date of distribution or transfer because on the date of distribution or transfer T Corporation's employment agency is larger than X Corporation's employment agency. The adjusted bases of the assets of T Corporation's employment agency exceed the adjusted bases of the assets of X Corporation's employment agency, and the gross receipts of T Corporation's employment agency exceed the gross receipts of X Corporation's employment agency. X Corporation need not secure the Commissioner's consent to use this method of accounting. However, in accordance with paragraph (d)(1) of this section, X Corporation must change the method of accounting for the employment agency business it operated prior to the date of distribution or transfer to the accrual method of accounting used by T Corporation's employment agency immediately prior to the date of distribution or transfer.

Example (4). Impermissible principal method.

(i) *Facts.* The facts are the same as in *Example (1)*, except that X Corporation is prohibited under section 448 from using the cash receipts and disbursements method of accounting after the date of distribution or transfer.

(ii) *Conclusion.* Because section 448 prohibits X Corporation from using the cash receipts and disbursements method of accounting, X Corporation is not permitted to use the principal method for the overall method of accounting as determined in *Example (1)*. Because after the date of distribution or transfer that method is not a permissible method, under paragraph (a)(4) of this section X Corporation must secure the Commissioner's consent to change to a permissible method in accordance with the procedures set forth in paragraph (d)(2) of this section.

Example (5). Voluntary change not allowable.

(i) *Facts.* The facts are the same as in *Example (4)*, except that T Corporation wants to discontinue using the overall accrual method of accounting for its employment agency and change to the cash receipts and disbursements method for the taxable year in which the section 381(a) transaction occurs or is expected to occur.

(ii) *Conclusion.* Under paragraph (a)(5) of this section, the Commissioner will grant a request to change a method of accounting for the taxable year that includes the date of distribution or transfer only if the requested

method is the method that the acquiring corporation must use after the date of distribution or transfer. The Commissioner will not consent to a request by T Corporation to change to the cash receipts and disbursements method for the taxable year in which the section 381(a) transaction occurs or is expected to occur because X Corporation cannot use the cash receipts and disbursements method after the date of distribution or transfer.

Example (6). Principal methods are the acquiring corporation's methods.

(i) *Facts.* X Corporation and T Corporation each publishes magazines. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. Both X Corporation and T Corporation use an overall accrual method of accounting. X Corporation has elected to defer income from its subscription sales under section 455. T Corporation has not elected to defer income from its subscription sales under section 455 and instead has recognized the income from these sales in accordance with section 451. The adjusted bases of the assets in X Corporation's publication business immediately prior to the date of distribution or transfer exceed the adjusted bases of the assets in T Corporation's publication business, and the gross receipts in X Corporation's publication business for the representative period exceed the gross receipts in T Corporation's publication business for the representative period. After the date of distribution or transfer, X Corporation will not operate its publication business as a trade or business that is separate and distinct from T Corporation's publication business.

(ii) *Conclusion.* Because after the date of distribution or transfer X Corporation will not operate its publication business as a separate and distinct trade or business, X Corporation must use the principal method under paragraph (a)(3) of this section, unless either the principal method is impermissible and must be changed under paragraph (a)(4) of this section or X Corporation changes the principal method in accordance with paragraph (a)(5) of this section. The adjusted bases of the assets in T Corporation's publication business do not exceed the adjusted bases of the assets in X Corporation's publication business, and the gross receipts in T Corporation's publication business do not exceed the gross receipts in X Corporation's publication business. Because on the date of distribution or transfer T Corporation's publication business is not larger than X Corporation's publication business, the principal method for the overall method of accounting is the accrual method used by X Corporation's publication business immediately prior to the date of distribution or transfer. The principal method for subscription sales is the section 455 deferral method used by X Corporation immediately prior to the date of

distribution or transfer. X Corporation need not secure the Commissioner's consent to use the principal method for either the overall method of accounting or the special method of accounting. However, in accordance with paragraph (d)(1) of this section, X Corporation must change both the overall method of accounting and the special method of accounting for the publication business acquired from T Corporation to the accrual method and the section 455 deferral method used by X Corporation immediately prior to the date of distribution or transfer.

Example (7). Principal methods are the acquiring corporation's methods. (i) *Facts.* The facts are the same as in *Example (6)*, except that the adjusted bases of the assets in T Corporation's publication business immediately prior to the date of distribution or transfer exceed the adjusted bases of the assets in X Corporation's business.

(ii) *Conclusion.* The result is the same as in *Example (6)*. Because on the date of distribution or transfer T Corporation's publication business is not larger than X Corporation's publication business, the principal method for the overall method of accounting is the accrual method used by X Corporation's publication business immediately prior to the date of distribution or transfer. The principal method for subscription sales is the section 455 deferral method used by X Corporation immediately prior to the date of distribution or transfer. X Corporation need not secure the Commissioner's consent to use the principal method for either the overall method of accounting or the special method of accounting. However, in accordance with paragraph (d)(1) of this section, X Corporation must change both the overall method of accounting and the special method of accounting for the publication business acquired from T Corporation to the accrual method and the section 455 deferral method used by X Corporation immediately prior to the date of distribution or transfer.

Example (8). Principal method determination when larger component trade or business does not have a special method of accounting. (i) *Facts.* X Corporation and T Corporation both install ice skating rinks. Both X Corporation and T Corporation use an overall accrual method of accounting for their respective businesses. X Corporation completes its installation contracts within the contracting year and uses an accrual method of accounting to recognize the revenue from its installation contracts. T Corporation's installation contracts are subject to section 460, and T Corporation recognizes the revenue from such contracts under the percentage-of-completion method. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. The adjusted bases of the assets in X Corporation's installation business immediately prior to the date of distribution or transfer exceed the

adjusted bases of the assets in T Corporation's installation business, and the gross receipts in X Corporation's installation business for the representative period exceed the gross receipts in T Corporation's installation business for the representative period. After the date of distribution or transfer, X Corporation will not operate its installation business as a trade or business that is separate and distinct from T Corporation's installation business.

(ii) *Conclusion.* Because after the date of distribution or transfer X Corporation will not operate its installation business as a separate and distinct trade or business, X Corporation must use a principal method under paragraph (a)(3) of this section, unless either the principal method is impermissible and must be changed under paragraph (a)(4) of this section or X Corporation changes the principal method in accordance with paragraph (a)(5) of this section. The adjusted bases of the assets in T Corporation's installation business do not exceed the adjusted bases of the assets in X Corporation's installation business, and the gross receipts in T Corporation's installation business do not exceed the gross receipts in X Corporation's installation business. Because on the date of distribution or transfer T Corporation's installation business is not larger than X Corporation's installation business, the principal method for the overall method of accounting is the accrual method used by X Corporation's installation business immediately prior to the date of distribution or transfer. X Corporation need not secure the Commissioner's consent to use the principal method for the overall method of accounting. However, in accordance with paragraph (d)(1) of this section, X Corporation must change the overall method of accounting for the installation business acquired from T Corporation to the accrual method used by X Corporation. Under paragraph (c) of this section, the principal method for T Corporation's long-term contracts is the percentage-of-completion method used by T Corporation immediately prior to the date of distribution or transfer because X Corporation's installation business does not have a method of accounting for long-term contracts. There is no change in method of accounting, and X Corporation need not secure the Commissioner's consent to use T Corporation's percentage-of-completion method.

Example (9). Principal method determination with a combined trade or business and a separate and distinct trade or business. (i) *Facts.* X Corporation operates a tennis academy as a trade or business that is separate and distinct from its trade or business of operating a golf academy. X Corporation uses the overall cash receipts and disbursements method of accounting for the tennis academy and an overall accrual method of accounting for the

golf academy. T Corporation operates a tennis academy and uses an accrual method of accounting for the overall method. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. After the date of distribution or transfer, X Corporation will not operate its tennis academy as a trade or business that is separate and distinct from T Corporation's tennis academy. X Corporation will continue to operate its golf academy as a trade or business that is separate and distinct from the operation of the tennis academy. The adjusted bases of the assets in T Corporation's tennis academy exceed the adjusted bases of the assets in X Corporation's tennis academy immediately prior to the date of distribution or transfer. The gross receipts of T Corporation's tennis academy for the representative period exceed the gross receipts of X Corporation's tennis academy for that period.

(ii) *Conclusion.* Because after the date of distribution or transfer X Corporation will not operate its tennis academy as a separate and distinct trade or business, X Corporation must use a principal method under paragraph (a)(3) of this section, unless either the principal method is impermissible and must be changed under paragraph (a)(4) of this section or X Corporation changes the principal method in accordance with paragraph (a)(5) of this section. Because on the date of distribution or transfer the tennis academy operated by T Corporation is larger than the tennis academy operated by X Corporation, the principal method for the overall method of accounting for the combined tennis academy business is the accrual method used by T Corporation's tennis academy immediately prior to the date of distribution or transfer. X Corporation need not secure the Commissioner's consent to use the principal method for the overall method of accounting. However, in accordance with paragraph (d)(1) of this section, X Corporation must change the method of accounting for its tennis academy to the accrual method. Because X Corporation will operate the golf academy as a separate trade or business, under paragraph (a)(2) of this section X Corporation must continue to use the accrual method that it used immediately prior to the date of distribution or transfer as the carryover method for the golf academy. There is no change in method of accounting, and X Corporation need not secure the Commissioner's consent to use the carryover method.

Example (10). Principal method determination with multiple component trades or businesses.

(i) *Facts.* The facts are the same as in *Example (9)*, except that after the date of distribution or transfer X Corporation will not operate its golf academy as a trade or business that is separate and distinct from the tennis academy. In addition, X Corporation's component trades or businesses are larger than T Corporation's component trade or business:

(1) the adjusted bases of the assets of X Corporation's tennis academy and golf academy businesses, in the aggregate, exceed the adjusted bases of the assets held by T Corporation's tennis academy; and (2) the gross receipts for the representative period of X Corporation's tennis academy and golf academy businesses, in the aggregate, exceed the gross receipts in T Corporation's tennis academy.

(ii) *Conclusion.* Because on the date of distribution or transfer T Corporation's tennis academy is not larger than X Corporation's combined tennis academy and golf academy, the principal method for the overall method of accounting is the method of accounting used by the component trades or businesses of X Corporation that will be combined with T Corporation's component trade or business on that date. Because on the date of distribution or transfer X Corporation operates two component trades or businesses with different overall methods of accounting that will be integrated after the date of distribution or transfer, X Corporation may choose under paragraph (c)(2) of this section which overall method (and any special method of accounting) used by its component trades or businesses will be the principal method. X Corporation may choose to use either the accrual method used by the golf academy or the cash receipts and disbursements method used by its tennis academy as the principal method after the date of distribution or transfer, if either method is a permissible method. In accordance with paragraph (d)(1) of this section, X Corporation must change T Corporation's overall method of accounting to the principal method. Under paragraph (a)(3) of this section, X Corporation also must change either its golf academy business or its tennis academy business, depending on which principal method X Corporation selects, to the principal method.

(d) *Procedures for changing a method of accounting—(1) Change made to principal method under paragraph (a)(3) of this section—(i) Section 481(a) adjustment—(A) In general.* An acquiring corporation that changes its method of accounting or the distributor or transferor corporation's method of accounting under paragraph (a)(3) of this section does not need to secure the Commissioner's consent to use the principal method. To the extent the use of a principal method constitutes a change in method of accounting, the change in method is

treated as a change initiated by the acquiring corporation for purposes of section 481(a)(2). Any change to a principal method, whether the change relates to a trade or business of the acquiring corporation or a trade or business of the distributor or transferor corporation, must be reflected on the acquiring corporation's federal income tax return for the taxable year that includes the date of distribution or transfer. The amount of the section 481(a) adjustment and the adjustment period, if any, necessary to implement a change to the principal method are determined under § 1.446-1(e) and the applicable administrative procedures that govern voluntary changes in methods of accounting under section 446(e). If the Internal Revenue Code, the Income Tax Regulations, or administrative procedures require that a method of accounting be implemented on a cut-off basis, the acquiring corporation must implement the change on a cut-off basis as of the date of distribution or transfer on its federal income tax return for the taxable year that includes the date of distribution or transfer. If the Internal Revenue Code, the Income Tax Regulations, or administrative procedures require a section 481(a) adjustment, the acquiring corporation must determine the section 481(a) adjustment and include the appropriate amount of the section 481(a) adjustment on its federal income tax return for the taxable year that includes the date of distribution or transfer and subsequent taxable year(s), as necessary. This adjustment is determined by the acquiring corporation as of the beginning of the day that is immediately after the date of distribution or transfer.

(B) *Example.* The following example illustrates the rules of this paragraph (d)(1)(i):

Example. X Corporation uses the overall cash receipts and disbursements method of accounting, and T Corporation uses an overall accrual method of accounting. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. X Corporation determines that under the rules of paragraph (c)(1) of this section X Corporation must change the method of accounting for the business acquired from T Corporation to the cash receipts and disbursements method. X Corporation will de-

termine the section 481(a) adjustment pertaining to the change to the cash receipts and disbursements method by consolidating the adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in the various accounts, such as accounts receivable, as of the beginning of the day that immediately follows the day on which X Corporation acquires the assets of T Corporation. X Corporation will reflect this adjustment, or an appropriate part thereof, on its federal income tax return for the taxable year that includes the date of distribution or transfer.

(ii) *Audit protection.* Notwithstanding any other provision in any other Income Tax Regulation or administrative procedure, no audit protection is provided for any change in method of accounting under paragraph (d)(1) of this section.

(iii) *Other terms and conditions.* Except as otherwise provided in this section, other terms and conditions provided in § 1.446-1(e) and the applicable administrative procedures for voluntary changes in method of accounting under section 446(e) apply to a change in method of accounting under this section. Thus, for example, if the administrative procedures for a particular change in method of accounting have a term and condition that provides for the acceleration of the section 481(a) adjustment period, this term and condition applies to a change made under this paragraph (d)(1). However, any scope limitation in the applicable administrative procedures will not apply for purposes of making a change under this paragraph (d)(1). For example, if the administrative procedures provide as a limitation that an identical change in method of accounting is barred for a period of years, this limitation will not bar a change to the principal method made under this section.

(2) *Change made to a method of accounting under paragraph (a)(4) or (a)(5) of this section—(i) In general.* A party to a section 381(a) transaction that changes a method of accounting under either paragraph (a)(4) or paragraph (a)(5) of this section must follow the

provisions of § 1.446-1(e) and the applicable administrative procedures, including scope limitations, for voluntary changes in method of accounting under section 446(e), except as provided in paragraphs (d)(2)(ii) and (d)(2)(iii) of this section. An application on Form 3115, "Application for Change in Accounting Method," filed with the IRS to change a method of accounting under this paragraph (d)(2) should be labeled "Filed under section 381(c)(4)" at the top.

(ii) *Final year limitation.* Any scope limitation relating to the final year of a trade or business will not apply to a taxpayer that changes its method of accounting in the final year of a trade or business that is terminated as the result of a section 381(a) transaction.

(iii) *Time to file.* Under the authority of § 1.446-1(e)(3)(ii), for a change in method of accounting requiring advance consent, the application for a change in method of accounting (for example, Form 3115) must be filed with the IRS on or before the later of—

(A) The due date for filing a Form 3115 as specified in § 1.446-1(e), for example, the last day of the taxable year in which the distribution or transfer occurred, or

(B) The earlier of—

(1) The day that is 180 days after the date of distribution or transfer, or

(2) The day on which the acquiring corporation files its federal income tax return for the taxable year in which the distribution or transfer occurred.

(e) *Rules and procedures—(1) No method of accounting.* If a party to a section 381(a) transaction is not using a method of accounting, does not have a method of accounting for a particular item, or came into existence as a result of the transaction, the party will not be treated as having a method of accounting different from that used by another party to the section 381(a) transaction.

(2) *Elections and adoptions allowed.* If an election does not require the Commissioner's consent, an acquiring corporation or a distributor or transferor corporation is not precluded from making any election that is otherwise permissible for the taxable year that includes the date of distribution or transfer. For purposes of this section, a cor-

poration shall be deemed as having made any election as of the first day of the taxable year that includes the date of distribution or transfer. Similarly, where adoption is permissible, an acquiring corporation or a distributor or transferor corporation may adopt any permissible method of accounting for the taxable year that includes the date of distribution or transfer.

(3) *Elections continue after section 381(a) transaction—(i) General rule.* An acquiring corporation is not required to renew any election not otherwise requiring renewal and previously made by it or by a distributor or transferor corporation for a carryover method or a principal method if the acquiring corporation uses the method after the section 381(a) transaction. If the acquiring corporation uses a method after the date of distribution or transfer, an election made by the acquiring corporation or by a distributor or transferor corporation for that method that was in effect on the date of distribution or transfer continues after the section 381(a) transaction as though the distribution or transfer had not occurred.

(ii) *Example.* The following example illustrates the rules of this paragraph (e)(3):

Example. The acquiring corporation, X Corporation, previously elected to amortize bond premium under section 171. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. X Corporation determines under the rules of paragraph (c)(1) of this section that X Corporation's method of amortizing bond premium is the principal method. After the date of distribution or transfer, X Corporation is not required to renew its bond premium amortization election and is bound by it. Additionally, X Corporation would not be required to renew its election to amortize bond premium if the method were the carryover method under paragraph (a)(2) of this section.

(4) *Appropriate times for certain determinations—(i) Determining the method of accounting.* The method of accounting used by a party to a section 381(a) transaction on the date of distribution or transfer is the method of accounting used by that party as of the end of the day that is immediately prior to the date of distribution or transfer.

(ii) *Determining whether there are separate and distinct trades or businesses after*

the date of distribution or transfer. Whether an acquiring corporation will operate the trades or businesses of the parties to a section 381(a) transaction as separate and distinct trades or businesses after the date of distribution or transfer will be determined as of the date of distribution or transfer based upon the facts and circumstances. Intent to combine books and records of the trades or businesses may be demonstrated by contemporaneous records and documents or by other objective evidence that reflects the acquiring corporation's ultimate plan of operation, even though the actual combination of the books and records may extend beyond the end of the taxable year that includes the date of distribution or transfer.

(5) *Representative period for aggregating gross receipts.* The representative period for measuring gross receipts is generally the 12 consecutive months preceding the date of distribution or transfer. If a component trade or business was not in existence for the 12 consecutive months preceding the date of distribution or transfer, then all component trades or businesses of each integrated trade or business will compare their gross receipts for the period that such trade or business was in existence. For example, if the acquiring corporation's component trade or business was formed in August and the date of distribution or transfer occurred in December of the same year, the gross receipts for those five months will be compared with the gross receipts of the other component trades or businesses for the same period.

(6) *Establishing a method of accounting.* A method of accounting used by the distributor or transferor corporation immediately prior to the date of distribution or transfer that continues to be used by the acquiring corporation after the date of distribution or transfer is an established method of accounting for purposes of section 446(e), whether or not such method is proper or is permitted under the Internal Revenue Code or any applicable Income Tax Regulations.

(7) *Other applicable provisions.* This section does not preempt any other provision of the Internal Revenue Code or the Income Tax Regulations that is

applicable to the acquiring corporation's circumstances. For example, income, deductions, credits, allowances, and exclusions may be allocated among the parties to a section 381(a) transaction and other taxpayers under sections 269 and 482, if appropriate. Similarly, transfers of contracts accounted for using a long-term contract method of accounting are governed by the rules provided in § 1.460-4(k). Further, if other paragraphs of section 381(c) apply for purposes of determining the methods of accounting to be used following the date of distribution or transfer, section 381(c)(4) and this § 1.381(c)(4)-1 will not apply to the tax treatment of the items. For example, this section does not apply to inventories that an acquiring corporation obtains in a transaction to which section 381(a) applies. Instead, the rules of section 381(c)(5) govern the inventory method to be used by the acquiring corporation after the distribution or transfer. Similarly, if the acquiring corporation assumes an obligation of the distributor or transferor corporation that gives rise to a liability after the date of distribution or transfer and to which § 1.381(c)(16)-1 applies, the deductibility of the item is determined under this section only after the rules of section 381(c)(16) are applied.

(8) *Character of items of income and deduction.* After the date of distribution or transfer, items of income and deduction have the same character in the hands of the acquiring corporation as they would have had in the hands of the distributor or transferor corporation if no distribution or transfer had occurred.

(9) *Method of accounting selected by project or job.* If other sections of the Internal Revenue Code, Income Tax Regulations, or other administrative guidance permit an acquiring corporation to elect a method of accounting on a project-by-project, job-by-job, or other similar basis, then for purposes of this section the method elected with respect to each project or job is the established method only for that project or job. For example, the election under section 460 to classify a contract to perform both manufacturing and construction activities as a long-term construction contract if at least 95 percent

of the estimated total allocable contract costs are reasonably allocated to the construction activities is made on a contract-by-contract basis. Accordingly, the method of accounting previously elected for a project or job generally continues after the date of distribution or transfer. However, if the trades or businesses of the parties to a section 381(a) transaction are not operated as separate and distinct trades or businesses after the date of distribution or transfer, and two or more of the parties to the section 381(a) transaction previously worked on the same project or job and used different methods of accounting for the project or job immediately before the distribution or transfer, then the acquiring corporation must determine the principal method for that project or job under paragraph (c) of this section and make changes, if necessary, to the principal method in accordance with paragraph (d)(1) of this section.

(10) *Impermissible method of accounting.* This section does not limit the Commissioner's ability under section 446(b) to determine whether a taxpayer's method of accounting is an impermissible method or otherwise fails to clearly reflect income. For example, an acquiring corporation may not use the method of accounting determined under paragraph (a)(2) of this section if the method fails to clearly reflect the acquiring corporation's income within the meaning of section 446(b).

(f) *Effective/applicability date.* This section applies to corporate reorganizations and tax-free liquidations described in section 381(a) that occur on or after August 31, 2011.

[T.D. 9534, 76 FR 45675, Aug. 1, 2011]

§ 1.381(c)(5)–1 Inventory method.

(a) *Introduction*—(1) *Purpose.* This section provides guidance regarding the inventory method an acquiring corporation must use following a distribution or transfer to which sections 381(a) and 381(c)(5) apply and how to implement any associated change in method of accounting. See § 1.381(c)(4)–1 for guidance regarding the method of accounting or combination of methods (other than inventory and depreciation methods) an acquiring corporation must use following a distribution or

transfer to which sections 381(a) and 381(c)(4) apply. See § 1.381(c)(6)–1 for guidance regarding the depreciation method an acquiring corporation must use following a distribution or transfer to which sections 381(a) and 381(c)(6) apply.

(2) *Carryover method requirement for separate and distinct trades or businesses.* In a transaction to which section 381(a) applies, if an acquiring corporation continues to operate a trade or business of the parties to the section 381(a) transaction as a separate and distinct trade or business after the date of distribution or transfer, the acquiring corporation must use a carryover method as defined in paragraph (b)(4) of this section for each continuing trade or business, unless either the carryover method is impermissible and must be changed under paragraph (a)(4) of this section or the acquiring corporation changes the carryover method in accordance with paragraph (a)(5) of this section. The acquiring corporation need not secure the Commissioner's consent to continue a carryover method.

(3) *Principal method requirement for trades or businesses not operated as separate and distinct trades or businesses.* In a transaction to which section 381(a) applies, if an acquiring corporation does not operate the trades or businesses of the parties to the section 381(a) transaction as separate and distinct trades or businesses after the date of distribution or transfer, the acquiring corporation must use a principal method determined under paragraph (c) of this section, unless either the principal method is impermissible and must be changed under paragraph (a)(4) of this section or the acquiring corporation changes the principal method in accordance with paragraph (a)(5) of this section. The acquiring corporation must change to a principal method in accordance with paragraph (d)(1) of this section for each integrated trade or business and need not secure the Commissioner's consent to use a principal method.

(4) *Carryover method or principal method not a permissible method.* If a carryover method or principal method is not a permissible inventory method, the acquiring corporation must secure the